Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of Petition for Forbearance From The Prohibition of Sharing Operating, Installation, and Maintenance Functions Under Section 53.203(a)(2) Of The Commission's Rules	**CC Docket No. 96-149**

Ex Parte Declaration

of

LEE L. SELWYN

on behalf of

AT&T Corp.

November 15, 2002

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EX PARTE DECLARATION OF LEE L. SELWYN

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Introduction

1. My name is Lee L. Selwyn; I am President of Economics and Technology, Inc. ("ETI"), Two Center Plaza, Suite 400, Boston, Massachusetts 02108. I submitted a Declaration on behalf of AT&T Corp. on August 5, 2002 in WC Docket 02-112, the Commission's *Notice of Proposed Rulemaking* regarding *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, and submitted a Reply Declaration in that proceeding on August 26, 2002. That same August 26, 2002 Reply Declaration was also submitted by AT&T in the instant proceeding, CC Docket No. 96-149. I have been asked by AT&T to prepare this *Ex Parte* Declaration responding specifically to certain assertions and opinions contained in the Reply Comments and accompanying Declarations submitted by Verizon Communications, Inc. ("Verizon") in the above-captioned matter on September 24, 2002.

2. With its Reply Comments, Verizon included, *inter alia*, a Declaration by Timothy J. Tardiff that purports "to respond to the economic arguments of those opposing Verizon's request that the FCC forbear from enforcing its current prohibition against Bell Operating Companies (BOCs) and their interLATA long distance affiliate sharing Operation, Installation, and Maintenance (OI&M) functions, with primary focus on the arguments proffered by Dr. Lee Selwyn."[1] In his Declaration, Dr. Tardiff opines that the OI&M restrictions are "unnecessary to ensure that long-distance services are competitive" and reiterates Verizon's contention that the Section 272(b)(1) "operate independently" requirement "impose[s] extra costs on BOCs."[2] As I shall demonstrate in this Declaration, Dr. Tardiff's various contentions and assertions misstate existing competitive conditions and operational practices, and are otherwise off-point and meritless.

There is no credible or verifiable proof of any cost savings from the integration of local and long distance OI&M functions, but even if such integration efficiencies were present, Verizon has not demonstrated that any such savings would be flowed through to consumers.

3. Verizon and Dr. Tardiff claim that the OI&M restriction "harms competition by handicapping the BOCs and by ultimately passing along the costs of this restriction to consumers."[3] They claim that this requirement "increas[es] the costs of production of firms subject to [the

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1. Declaration of Timothy J. Tardiff on behalf of Verizon, September 24, 2002, at para. 2.

2. *Id.*, at para. 2.

3. *Id.*, at para. 4.

restrictions], thus denying consumers the full benefits of competition."[4] In support of its claim, Verizon offers a three-page Declaration together with a three-page Attachment by Fred Howard, President of Verizon Global Networks, Inc. ("GNI"). Mr. Howard testifies that "GNI would save approximately $183 million over the 2003 through 2006 time period by sharing [OI&M] services with the BOC."[5] This estimate, which Mr. Howard claims to be "conservative," is supported by the three-page attachment that provides what can best be described as "ball park" estimates of costs that GNI would avoid if the specified function was, in each case, carried out by the BOC.

4. For example, Mr. Howard's Attachment notes that, for Professional Services, Mr. Howard claims savings from OI&M integration of *95%*, explaining that:

> Professional Services consist of the expenses for third-party vendors, primarily to perform field work. If GNI had not been constrained by the Commission's rules prohibiting sharing of operating, installation, and maintenance functions with the BOC, this cost could have been avoided almost entirely by using existing BOC field technicians.[6]

Although Mr. Howard is entirely silent as to precisely how this "95% savings" would arise, it is difficult to imagine how BOC field technicians could perform the same "field work" *in 5% the time* that it would take GNI personnel or outside vendors to accomplish the equivalent functions. There are several possible explanations. Mr. Howard may have omitted from his analysis the

4. *Id.,* at para. 25.

5. Verizon Reply Comments, September 24, 2002, Attachment A, at para. 5.

6. *Id.*, at 2.

cost of the BOC personnel or the fact that, as required by 47 U.S.C. 272(b)(5), GNI would have to pay the BOC the fair market value of the services that the BOC provides. In this case, since GNI is apparently purchasing these services from "third-party vendors," the arm's length "fair market value" would be the price that GNI is currently paying to the non-affiliated providers of these services. Perhaps Mr. Howard is assuming that BOC field technicians have so much "free time" on their hands that these added responsibilities (of supporting Verizon's interLATA affiliate) would not require the BOC to recruit, train, and *pay* additional employees, or require significant overtime from current employees. That would, of course, indicate the presence of a major inefficiency within the BOC entity that has *nothing whatever to do with the required separation of OI&M functions*. In any event, there is no basis upon which the veracity of Mr. Howard's "95% savings" estimate can be tested or reproduced, and as such his statements are nothing more than numbers on a page, establishing *nothing* about the actual "savings" that Verizon might realize, *if any*, from OI&M integration.

5. In a similar vein, Mr. Howard claims that GNI could save 65% of the costs associated with the development of its own operations support systems ("OSS") because these systems "could have been developed through modification of the BOC systems and reused at a fraction of the costs incurred to develop new systems."[7] As with "Professional Services," no specific data or support is offered for this particular estimate. More to the point, there is no indication, from Mr. Howard's attachment, that he has included any "right-to-use fee" that the Verizon BOC might impose upon GNI for the ability to access and modify the BOC-owned systems. Indeed,

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7. *Id.*

Verizon (and its predecessors Bell Atlantic and NYNEX) have in the past represented to this Commission and to a number of state commissions that substantial costs are involved in order to modify existing BOC OSSs to accommodate interactions with CLECs, and have argued that these added costs should be borne by CLECs.[8] Absent anything more specific than Mr. Howard's "ball park" figure of 65% OSS savings, Verizon's claims as to savings and efficiency gains through OI&M integration lack credibility and must be afforded zero weight.

6. Virtually all of the "categories" identified on Mr. Howard's Attachment A suffer from the same deficiencies. No specific basis or source is offered for the "savings estimates" that are presented, and there is no specific indication that any added costs that the BOC would incur upon acquiring the responsibility for each and all of these functions, let alone the *price* that the BOC would be required to charge GNI for these services pursuant to 47 U.S.C. 272(b)(5), have been included, if in fact they had even been considered at all. Accordingly, and without specifically addressing each expense category individually, it is clear that Mr. Howard's estimates of efficiency gains are devoid of credibility and should be dismissed by the Commission.

8. *Investigation by the Department of Telecommunications and Energy on its own Motion into the Appropriate Pricing, based upon Total Element Long-Run Incremental Costs, for Unbundled Network Elements and Combinations of Unbundled Network Elements, and the appropriate Avoided-Cost Discount for Verizon New England, Inc. d/b/a Verizon Massachusetts' Resale Services in the Commonwealth of Massachusetts,* Before the Massachusetts Department of Telecommunications and Energy, Docket No. 01-20, Direct Testimony of Louis D. Minion (Verizon), May 4, 2001. In its *Order*, filed July 11, 2002, the Massachusetts Commission concurred that Verizon would realize costs for changing its OSS.

7. Verizon claims that structural separation of OI&M functions increases the long distance affiliate's OI&M service costs above the BOC's marginal cost of providing the service for the affiliate on an integrated basis.[9] However, the "marginal costs" that Verizon cites are in any event *not* the appropriate cost comparison in this case, and cannot be used to estimate the "cost savings" that Verizon would realize. Were Verizon to properly apply the "arm's length" requirements of Section 272(b)(5) as implemented by this Commission, Verizon's long distance affiliate would be required to purchase all non-tariffed services from the BOC at the higher of fully distributed cost or fair market value.[10] In the case of OI&M functions, the price that Verizon is currently paying third party contractors and/or the affiliate's cost of providing this service in-house provides a reasonable and accurate fair market value. Verizon LD would therefore recognize the same OI&M costs regardless of the entity providing the service and regardless of whether it was being provided on an integrated or a stand-alone basis.

8. Assuming that Verizon adheres to the Section 272(b)(5) "arm's length" requirement, whatever cost savings may result from OI&M integration with the BOC entity would necessarily inure solely to the BOC (because the affiliate's transfer price payment for integrated OI&M services should be the same as its costs of performing these same functions on a stand-alone basis). In that case, BOC customers will realize those (alleged) cost savings *if and only if* the BOC is required (by the state PUC) to pass them through to its monopoly service ratepayers in the form of lower rates, *something that is not typically required or even contemplated under*

9. Verizon Reply, at 1.

10. *Accounting Safeguards under the Telecommunications Act of 1996*, CC Docket No. 96-150, *Report and Order*, 11 FCC Rcd 17539, 17606-17607.

existing state PUC incentive regulation paradigms. If the long distance affiliate were to price its long distance services so as to pass through the savings from integration, that would amount to below-cost pricing relative to what is actually being — or that should be — recognized on the long distance entity's books.

9. Indeed, Dr. Tardiff himself notes that price cap regulation prevents efficiency benefits from flowing to ratepayers. Dr. Tardiff recognizes that price caps "supply stronger incentives on the part of the regulated firms to improve their efficiency, since they retain the benefits of any such cost reductions– subject of course to reexamination of the price cap formulas."[11] Dr. Tardiff's statement concedes that, under price cap regulation, the BOC would have no incentive *or requirement* to pass on revenues generated from provision of OI&M services to its affiliates to anyone but its shareholders. Verizon's only incentive to pass on revenues in the form of lower local costs would be if competitive pressures required Verizon to reduce its local service prices. Verizon has presented no evidence that it is unable to compete with CLECs in the local market at or near its current retail prices. In fact, Verizon has recently asked for (and received) local price *increases* in New York,[12] and has made similar proposals in several other states.[13]

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11. Tardiff, at para. 24.

12. Verizon Press Release, *New York PSC Approves Verizon Regulatory Plan, Company Announces First Basic Rate Increase in 11 Years,* February 27, 2002.

13. "Verizon Wants to Raise Local Rates," *The Standard-Times*, June 7, 2002, at A10; "Verizon to Change Various Telephone Rates Under Price Cap Filing," Missouri PSC Press Release, available at http://www.psc.state.mo.us/press/pr0177.pdf.

10. Verizon also has no incentive to lower long distance rates. Currently, IXCs must account for a number of costs when establishing long distance and integrated service consumer prices. Included in this calculation are, *inter alia,* access charges, non-access network switching and transport costs, billing and collection costs, marketing costs, and customer service costs. In an effectively competitive market, the offered prices would be expected to roughly correspond with the sum of these costs. High cost producers would be forced either to take steps to reduce costs or to exit the market. A low cost producer, on the other hand, would be able to retain as excess profits the difference between its costs and the prevailing industry cost level. These excess profits would be short lived. Ultimately, rivals would come to match the low cost producer's efficiencies, and those rivals would have an incentive to gain market share by reducing prices. This price reduction cannot be expected to occur, however, if a firm's cost reduction is based on a *unique* ability to operate at lower cost that is not available to other firms. In this situation, the low cost company would continue to reap excess profits until and unless its unique status was compromised.

11. A BOC's ability to provide local and long distance service on an integrated basis would be an example of a unique capability, which could persist until such time, if ever, that competing *local service providers* acquire a sufficiently large customer base, without marketing costs significantly higher than those of the BOCs, to allow for similar integration. With BOCs currently controlling 90% or more of the residential and small business local service market and with even the largest individual CLEC shares falling in the low single-digit percentage range, the ability of BOCs to retain such excess profits or, alternatively, to temporarily set long distance prices below

their rivals' costs for the purpose of rapidly gaining long distance market share, is likely to persist for many years to come.

Preliminary results of BOC long distance entry following Section 272 approval confirm that the BOCs will continue to monopolize the local market and will come to monopolize the long distance market as well.

12. Dr. Tardiff states that "[a]n ounce of .. actual experience is surely weightier than a pound of speculation about possible misdeeds and/or, predictions of re-monopolization."[14] What we have here, of course, is not just "an ounce of actual experience," but rather a *ton* of it, acquired in the aftermath of BOC interLATA entry following their receipt of Section 271 authority. That "actual experience" not only confirms prior concerns as to the inadequacy of existing structural and non-structural safeguards as *implemented* by the Commission, but shows that my original projections of BOC long distance market share growth following 271 authorization to have been *highly conservative*.[15] Affording Verizon the "forbearance" from the OI&M separation required by Section 272(b)(1) as applied by the Commission will serve only to accelerate the demise of competition and enable Verizon to further consolidate its already formidable stranglehold on the local telecommunications market and come to remonopolize the long distance market within its operating footprint. The inextricable linkage between Verizon's and SBC's success in rapidly acquiring long distance customers and the BOCs' continuing

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14. Tariff, at para. 7.

15. I have provided a model predicting a BOC's ability to gain in-region market share in the Virginia and New Jersey Section 271 cases before this Commission. In addition, this model was included in the records developed by Delaware and California during their section 271 proceedings.

dominance of the local service market in their respective service areas is indisputable. Virtually all of Verizon's and SBC's 16-million long distance customers are *also* their local service customers.[16] Neither firm actively markets long distance service to customers of other ILECs, or of CLECs within the BOCs' footprint.

13. That BOC remonopolization of long distance is a clear and present danger, and not mere speculation, can be easily demonstrated by looking at the experience in Connecticut. The Southern New England Telephone Company ("SNET") was not a "Bell Operating Company" subject to the 1984 break-up of the former Bell System.[17] SNET was never barred from offering long distance service, and has not been required to comply with the separate affiliate, code of conduct, or other BOC specific provisions. *SNET operates its local and long distance activities on a fully integrated basis*. Hence, SNET provides a useful benchmark against which the potential consequences of granting Verizon's petition may be evaluated. And, as it happens, the experience in Connecticut — the details of which were just recently disclosed by SBC at an October 24, 2002 conference call with financial analysts — serves to confirm the real possibility

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16. As of the end of the third quarter of 2002, Verizon reported that it had acquired 9.8-million long distance customers, and SBC reported that it was serving some 5.9-million customers. *Verizon Investor Quarterly*, 3rd Quarter 2002 Quarterly Report, October 25, 2002, ("*Verizon 3Q Report*") at 5; *SBC Investor Briefing*, 3rd Quarter 2002 Quarterly Report, October 24, 2002, ("*SBC 3Q Report*") at 5.

17. Neither SNET nor Cincinnati Bell were made parties to the MFJ. See *United States v. American Telephone and Telegraph Company, Western Electric Company, Inc., and Bell Telephone Laboratories, Inc.; United States of America v. Western Electric Company, Inc., and American Telephone and Telegraph Company; United States of America v. American Telephone and Telegraph Company, et al.* Civil Action Nos. 74-1698, 82-0192, Misc. No. 82-0025 (PI), 552 F. Supp. 131, 228, 232 (Appendix A) (D.D.C 1982).

of BOC remonopolization of the long distance market, and directly contradicts and refutes Dr. Tardiff's unsupported contention that there is "no likelihood that history will repeat itself"[18] insofar as BOC remonopolization of the long distance market is concerned.

14. SNET began preliminary marketing efforts with respect to long distance service in approximately 1994[19] with a full-blown marketing program targeted at its retail consumer and small business local service customers beginning in early 1996, thus making Connecticut the most "mature" market in which a major ILEC with a near-statewide footprint offers local and long distance service on an integrated basis.

15. SNET was acquired by SBC Communications, Inc. in 1998.[20] In its third quarter 2002 conference call with financial analysts held on October 24,[21] SBC described its Connecticut long distance market share as "60-plus percent" and characterized that level as a "plateau market-

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18. Tardiff, at para. 5.

19. Previously, the Company cautiously entered the long distance market through an affiliate, SONECOR, whose activities were targeted primarily at larger business customers both within and outside of Connecticut.

20. *Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from; Southern New England Telecommunications Corporation, Transferor To SBC Communications, Inc., Transferee*, CC Docket No. 98-25, *Memorandum Opinion and Order*, Rel. October 23, 1998, 13 FCC Rcd. 21292.

21. *SBC Communications – 3Q 2002 Financial Release Conference Call,* October 24, 2002 ("*SBC 3Q Conference Call*"). (The audio file is available at: http://www.firstcallevents.com /service/ajwz368853844gf12.html)

share" that could be expected to be achieved in other such "mature" markets.[22] In response to a question from a participant in the conference call ("I am wondering if you have any insight into what your take rate is for LD among those customers who come in for the first time to order local service, which may be a better indicator of what long-term market share is for you guys?"), SBC also indicated that its "take rate" for long distance "tends to be in excess of 50 percent."[23]

16. Data from Verizon and from the other SBC states in which the BOCs have obtained interLATA authority indicate that Connecticut is anything but anomalous. Verizon has just announced that, as of the end of the third quarter of 2002, it has almost made its previously-announced year-end 2002 target of 10-million or more long distance customers.[24] Verizon consistently adds almost 800,000 new long distance customers per quarter.[25] Although Verizon does not release market penetration data for many of its most mature markets, the Company has announced that it has achieved over a 30% market share in New York in less than two years,[26] and has recently reported that it has already achieved a 9% consumer long distance market share

22. *Id.*

23. *Id.*

24. *Verizon 3Q Report,* at 4.

25. *Id.*, at 5.

26. *Verizon Communications Reports Solid 3Q Earnings and Provides Outlook for Remainder of 2001*, Verizon Press Release, October 30, 2001.

in Vermont and Maine after only three months following its entry into the long distance market in those states.[27]

17. SBC makes clear that this rapid market penetration growth in Connecticut is directly related to SBC/SNET's position as the monopoly local exchange service provider. The "in excess of 50 percent" take rate described by SBC's Randall Stephenson appears not to be related to the launch of SBC long distance services following Section 271 authority, nor does it correlate to the introduction of any new pricing plans or other SBC "innovations." Despite not entering any additional states, not introducing any new calling plans or implementing any new marketing initiatives in the third quarter of 2002, SBC's long distance affiliate nevertheless added 318,000 lines across the SBC "271" states during the third quarter of 2002, compared to 266,000 added in the second quarter.[28] It is likely that the vast majority of these increases are a result of marketing efforts by SBC local customer service representatives on inbound calls initiated by the customer for the purpose of ordering or otherwise dealing with *local* service matters unrelated to SBC long distance service.

27. *Verizon 3Q Report*, at 5.

28. *SBC 3Q Report,* at 5; *SBC Investor Briefing*, 2nd Quarter 2002 Quarterly Report, July 23, 2002, at 1.

SBC and Verizon present disingenuous claims regarding CLECs competitive advantage in providing integrated OI&M functions.

Verizon and SBC have announced significant successes in the business market.

18. Verizon argues that the OI&M restriction is particularly burdensome in the large business market.[29] Actual market experience, however, indicates that the BOCs are not suffering significant handicaps in this sector. In recent Quarterly statements, both SBC and Verizon touted their successes in acquiring interLATA business customers. SBC notes, for example, that:

> SBC's growth in business long-distance services continues to be strong. In the third quarter, business interLATA revenues in the five Southwestern Bell states grew more than 30 percent year over year, and interLATA revenues for medium- and large-business customers increased more than 80 percent sequentially from the second quarter this year, the company's largest sequential growth category to date.[30]

SBC has also had significant success with winback rates exceeding 50 percent in *both* the consumer and business market segments.[31]

19. Verizon's third quarter 2002 report also indicates that it is making inroads in the large business segment:

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29. *Verizon Petition for Forbearance*, filed August 5, 2002, at 6.

30. *SBC 3Q Report*, at 5.

31. *Id.*

> We also have significant enterprise market opportunity that will fully open up when we get complete 271 authorizations in all states. However, we are not waiting to develop these opportunities in states where we are permitted to provide LD services today. We have had several contract wins and are gaining traction with wins for interLATA data services on either a statewide or regional basis, where we have 271 relief, and we have very active pipeline of bids, as well. In the coming weeks you will be hearing more from us on how we plan to more actively address opportunities to gain market share in the enterprise business phase.[32]

Verizon's President and CEO recently boasted to financial analysts that "[w]hen we enter the business market for the full sweep and we focus on those customers that we're best positioned with, we'll get between 20 and 30 percent of the market in three years."[33] This "positioning" discussed by Verizon CEO Ivan Seidenberg directly relates to the ability of the BOC to integrate local and long distance facilities, leveraging older, legacy local services as opposed to the recently-acquired next-generation facilities being touted by Dr. Tardiff. Mr. Seidenberg noted that, due to segmentation in the business market, Verizon cannot meet the needs of "Tier One Global Markets" currently served by AT&T, Sprint and MCI. According to Seidenberg, Verizon does not have the networks required, and has no intention of building them.[34]

20. This long distance market success and the extraordinary rate of targeted penetration growth directly contradict Dr. Tardiff's assertion that "the OI&M restriction is especially

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32. Verizon 3rd Quarter Earnings Conference Call Webcast, October 25, 2002. (The audio file is available at http://investor.verizon.com/news/20021025/)

33. Ivan Seidenberg, remarks at the Goldman Sachs Communacopia XI Conference, October 1, 2002. (The audio file is available at http://investor.verizon.com/news/20021001/)

34. *Id.*

onerous."[35] Dr. Tardiff and Verizon argue that they are "disadvantaged" relative to their CLEC rivals by virtue of the CLECs' ability, so they claim, to provide end-to-end service and perform end-to-end testing over the CLECs' own facilities, whereas for BOCs the OI&M restriction requires separation of the interLATA and "last mile" local access facilities. That claim, of course, presupposes that CLECs control massive quantities of "last mile" facilities which, in point of fact, they do not.[36]

Verizon greatly exaggerates the number of CLEC owned "last mile" facilities.

21. In the *UNE Triennial Review* as well as in various Section 271 consultative proceedings held at the state level, BOCs have sought to portray as extensive the overall quantity of CLEC services being furnished over CLEC-owned facilities by means of a calculation that subtracts resold lines, UNE-P lines, and UNE loops from an estimate of total CLEC lines that the BOCs have derived by mining data from E911 databases.[37] Testimony filed by AT&T in the

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35. Tardiff, at para. 15.

36. Reply Declaration of Lee L. Selwyn in WC Docket No. 02-112 (AT&T), filed August 26, 2002, at para. 15-18.

37. Because BOC or other ILEC personnel typically administer the E911 database, they have the unique ability to access proprietary data that had been provided by each LEC *for the sole and specific purpose of populating the E911 database with information on the location of those LECs' customers*. In this regard and as an aside, ILECs' use of the carrier E911 database to extract market information is in itself evidence of an abuse of their monopoly position. There is a fundamentally unfair asymmetry in the fact that Verizon and the other BOCs, contrary to the express requirements of Section 222(b), utilize this proprietary data to make various claims in regulatory proceedings (and perhaps for other strategic purposes as well), but commenters are not afforded access to this data and are thus not able to evaluate the factual basis for the BOCs' claims. As a policy matter, allowing Verizon use of the E911 data for this purpose would

(continued...)

Commission's *UNE Triennial Review* proceeding explain that Verizon's claims that CLECs provide between 11- and 19-million business lines over their own facilities misrepresent the facts. As AT&T explains:

> The ILECs can reach this conclusion only by using a Rube Goldberg methodology that treats *CLEC purchase of special access as the CLECs' self-deployment of their own loops*. Thus, once this patent flaw is corrected, the number of self-deployed loops calculated by the ILECs' approach drops to the minimal level reflected in the Commission's own data and the comments.[38]

22. The data being cited by Dr. Tardiff appears to rely upon the same ILEC-sponsored *UNE Fact Report*[39] that was proffered by the ILECs in the *UNE Triennial Review.* Basing his conclusions on this report inevitably grossly overstates the number of CLECs serving customers over their own last mile facilities. The *UNE Fact Report* grossly exaggerates the extent of facilities-based CLEC lines (1) by relying upon quantities of CLEC telephone *numbers* contained in E911

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37. (...continued)
undermine the competitive safeguard, set out at Section 222(b) of the federal Act, that "[a] telecommunications carrier that receives or obtains proprietary information from another carrier for purposes of providing any telecommunications service shall use such information only for such purpose, and shall not use such information for its own marketing efforts."

38. *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers,* CC Docket No. 01-338; *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Docket No. 96-98, *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket No. 98-147 ("*UNE Triennial Review")*, *Reply Comments of AT&T Corp.*, filed July 17, 2002, at 145.

39. *Review of the Section 251 Unbundling Obligation of Incumbent Local Exchange Carriers*, CC Docket 01-338; *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996*, CC Docket 96-98; *Deployment of Wireline Services Offering Advanced Telecommunications Capability*, CC Docket 98-147, *UNE Fact Report 2002,* Submitted by BellSouth SBC, Qwest, and Verizon, April 2002.

databases, which overstate the total quantity of CLEC *lines* that actually exist; and (2) by including as CLEC-owned facilities the Special Access services that CLECs purchase from ILECs where CLEC use of UNEs is not permitted.[40]

23. Inasmuch as CLECs do not control anything close to the quantity of CLEC-owned facilities as Dr. Tardiff claims, a CLEC would be completely unable to provide integrated end-to-end services of the type being contemplated by Verizon, which owns "last mile" access facilities to literally *tens of millions* of residential and business locations. *The vast majority of CLEC and IXC "last mile" access connections are obtained from BOCs and other ILECs either as UNEs or, in the case of interexchange carriers, switched or special access services*. With respect to such serving arrangements, end-to-end testing and repair would be reported by the customer to its CLEC or IXC service provider, which would in turn be required to request service testing or repair over special access circuits from the BOC. This process is *exactly* the same process that Verizon requires from CLECs attempting end-to-end testing or repair over Verizon UNE or special access facilities. Verizon's *Petition* amounts to a request that the Commission allow Verizon to integrate operations on *millions of legacy monopoly local service lines*, and attempts to justify this request by citing isolated instances where CLECs are able to similarly integrate such services. Verizon's sought "remedy" is vastly out of proportion to any possible "harms" it suffers from the small number of CLECs able to provide integrated services.

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40. *Implementation of the Local Competition Provisions Of the Telecommunications Act of 1996*, CC Docket No. 96-98, *Supplemental Order Clarification*, Rel. June 2, 2000, 15 FCC Rcd 9587.

Despite Dr. Tardiff's assertions of a changing telecommunications industry, the BOCs' stranglehold on local facilities, as well as entrenched regulatory definitions, make the divestiture of AT&T relevant to BOC long distance entry.

24. It is the millions of legacy monopoly "last mile" facilities that Dr. Tardiff pointedly ignores when he denies the unambiguous relationship between Sections 271-272 of the *Telecommunications Act of 1996* ("Act") and its predecessor the *Modification of Final Judgment* ("MFJ"). Dr. Tardiff offers the simplistic and largely irrelevant suggestion that "[b]ecause of changes in technology, law, regulation, and competition itself ... 2002 is not 1984."[41] 2002 is not 1984 and, to be sure, *some* things have indeed changed or evolved in the eighteen years following the break-up of the former Bell System. But what has not changed — and what Dr. Tardiff seeks to brush off — is the inescapable *fact* that the incumbent Bell Operating Companies persist in their overwhelming dominance of the local exchange service infrastructure nationwide. That is decidedly *not* what Congress expected to be the case some seven years following enactment of the 1996 legislation. Yet, since 1996 all that has occurred is that BOCs and other ILECs have become bigger (through mergers) and more powerful (through their persistent bottleneck control of core local network resources and seemingly limitless litigation to frustrate and delay CLEC efforts to access ILEC network resources), and competitors and the capital needed to support their efforts have been vanquished and have vanished. By conveniently ignoring this market reality, Dr. Tardiff advances his "2002 is not 1984" hyperbole as providing some sort of substantive basis for the Commission to dismiss the real and growing threat to competition in the telecommunications industry that exists today as a direct result of the continuing discriminatory and anticompetitive conduct on the part of the BOCs.

41. Tardiff, at para. 5.

25. Dr. Tardiff claims that the "old distinctions between intra- and interLATA services are increasingly meaningless."[42] The OI&M prohibition, according to Dr. Tardiff, attempts to maintain this antiquated distinction, forcing the BOCs to operate less efficiently. While Dr. Tardiff may be correct that, technologically, many of the old distinctions are no longer efficient, he omits the reality that regulation and competition have not kept up with technology. IntraLATA access charges, for example, are still being set well in excess of cost. By forcing competing carriers to pay these excessive access charges to the very same BOCs with which they compete, the historical local/toll distinctions are being maintained notwithstanding what could happen but for the BOCs' enduring local bottleneck.

26. November 13, 2002 Market convergence naturally benefits a company with over whelming dominance in one of the converging markets. Dr. Tardiff thus conveniently ignores and, where he can't, seeks to minimize and understate, the very real evidence of continuing BOC local dominance when he claims that "[i]n particular, there is no likelihood that history will repeat itself if regulations such as the OI&M restriction were not applied." But history *is* repeating itself. BOCs *are* using their continuing dominance of the local exchange service market to rapidly capture a correspondingly dominant position in the adjacent long distance market within a short time following their attainment of Section 271 in-region interLATA authority. BOCs *are* cross-subsidizing their long distance activities by failing to compensate their ILEC entities for the fair market value of the myriad of services that are being provided to the long distance affiliate including, in particular, preemptive access to "inbound" local service

42. *Id.*, at para. 26.

customers ordering new local service and, for that matter, to the entirety of the BOC's local service customer base. Dr. Tardiff and Verizon ignore or dismiss the *mountain of evidence* confirming that not only do the BOCs retain a virtual monopolies in local markets, but they are gaining interLATA market share so rapidly that they will soon come to remonopolize the inter-LATA market as well.[43]

Dr. Tardiff's examples of developing competition in the intraLATA, InterLATA corridor, information services and CPE markets do not provide probative evidence contradicting the trend toward BOC remonopolization of the long distance market.

27. Given Verizon's and SBC's own reports of success in marketing to medium and large business customers, it is unlikely that they are substantially burdened by OI&M separation requirements. In fact, SBC's recognition of the success of "winback" efforts on the business side (where presumably the customer had previously been served by a CLEC not subject to the OI&M restriction) indicates that customers either do not value the carrier's ability to provide end-to-end testing (which the BOCs claim that they are unable to do) or that competitors are similarly unable able to provide end-to-end testing because they, like the BOC's Section 272 affiliate, are required to obtain "last mile" connections from the BOC ILEC entity.

28. Verizon's attempt to link the Commission's previously successful efforts at introducing competition into BOC bottleneck monopolies ignores important factors that render any such comparisons meaningless. Verizon cites four examples of "comparable" markets where the

43. See discussion at paras. 12-17, *supra.*

BOCs claim to have lost significant market share, despite their ability to provide these services on an operationally integrated basis with their local offerings.

InterLATA Corridor Traffic.

29. Under the terms of the MFJ, two "corridors" were established in the New York/New Jersey and Philadelphia/New Jersey metropolitan areas, respectively, within which the BOCs serving these areas (then Bell Atlantic and NYNEX, now Verizon) were permitted to carry inter-LATA traffic. However, upon implementation of interLATA equal access in the mid-1980s, *the so-called "corridor" traffic was subject to the same interLATA PIC as all other interLATA traffic*. Seeming to ignore this critically important fact, Dr. Tardiff notes that Bell Atlantic's ability to provide interLATA corridor traffic on an operationally integrated basis with its local services did not do anything to help it to retain market share, which has by now dropped to insignificant levels.[44] However, in the case of "corridor" calling, customers were *never* afforded the ability or opportunity to specify a separate "corridor" PIC. Hence, unless the caller made a special effort to "dial around" her selected interLATA PIC by using a 101-XXXX access code to use BOC "corridor" service (which among other things would require that the customer accurately identify particular calls as falling within the "corridor"),[45] those calls would

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44. Tardiff, at para. 9.

45. Except for the New York end of the New York/New Jersey "corridor," which consisted specifically of the five New York City boroughs that could be easily identified by the '212' and later the '212' and '718' area codes (thus enabling northern New Jersey customers to readily determine that calls made to these area codes could be dialed as "corridor" calls), the northern New Jersey, Camden and Philadelphia portions of the corridors were subsets of the (then) '201',
(continued...)

automatically be routed to the caller's interLATA PIC. Contrary to Dr. Tardiff's "spin," the BOCs' lack of success in retaining "corridor" market share does not "disprove" the importance of the OI&M restriction in protecting competition, but rather confirms the extreme importance of dialing parity.

IntraLATA Toll.

30. Dr. Tardiff observes that there are no OI&M or other separation requirements applicable as between the BOCs' local and their *intraLATA* toll operations, and yet notes that the BOCs have lost substantial intraLATA market share since intraLATA equal access was implemented nationwide around 1999. He cites this loss of BOC market share as further evidence that OI&M integration does not provide the BOCs with any competitive advantage vis-a-vis competing IXCs.[46] The evidence shows otherwise.

31. Dialing parity does exist today with respect to intraLATA toll, and while competition is present, BOCs continue to dominate this segment. As discussed at considerable length in my August 5, 2002 Declaration in the 272 Sunset proceeding,[47] intraLATA toll/local integration permits the BOCs to provide end-to-end service *without utilizing switched access services* of the

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45. (...continued)
'609', and '215' area codes, respectively, making it extremely difficult for a customer dialing a "corridor" number to readily associate a given call to these NPAs as presenting a BOC "corridor service" option.

46. Tardiff, at para. 8.

47. *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements,* WC Docket No. 02-112, Declaration of Lee L. Selwyn, filed August 5, 2002, at paras. 58-59.

type that are provided to IXCs, and in so doing gain cost and operational advantages that have enabled BOCs to offer retail intraLATA services at or below access charge levels. In fact, Dr. Tardiff appears to concede this point, noting that IXCs "had to compete against inexpensive local calling within the LATA"[48] Although IXCs have been successful in encouraging many customers to select the IXC for both intraLATA and interLATA service, the fact that the BOCs continue to provide intraLATA toll to nearly half of all local service customers *even though 100% of those customers are required to affirmatively select a separate interLATA carrier* serves to underscore the enormous value of the BOCs' incumbency and operational integration.[49] If OI&M separation is eliminated, BOCs will acquire the same capabilities with respect to *inter-LATA* services as they have enjoyed with respect to *intraLATA* — the ability to provide inter-LATA services on an end-to-end basis without the need to purchase and utilize the same types of

48. Tardiff, at para. 8. In New Jersey, for example, Verizon customers can purchase "Selective Calling Service" affording up to eight (8) hours of flat-rate calling (and low per-minute rates for usage in excess of that level) to nearby exchanges that would otherwise be subject to toll charges. Rates for Selective Calling service may be as low as $5.83 for a 24 hour block-of-time to three nearby exchanges, amounting to as little as $0.004 per minute (Verizon New Jersey Inc, Tariff B.P.U.- N.J. No. 2, Exchange and Network Services, Sixth Revised page 21, effective June 18, 2001). Verizon's intraLATA switched access charges that an IXC would pay to provide an intraLATA call in New Jersey amount to $0.017868. Verizon New Jersey Inc. B.P.U. NJ Tariff No. 2, Exchange and Network Services, Sixth Revised Page 21, Effective June 18, 2001. Similar optional expanded local calling plans can be found in other states, including Massachusetts (New England Telephone and Telegraph Company, MADTE No. 10, Exchange and Network Services, Part A Section 10, effective July 14, 1999).

49. Dr. Tardiff puts BOC intraLATA toll *revenue* shares at roughly 45%. Tardiff, at fn. 10. Since IXC shares include services furnished to customers over special access facilities leased from ILECs, the BOC share of the "dial-1" intraLATA toll market is undoubtedly well in excess of that 45% level. Additionally, the "toll" revenues cited by Tardiff *exclude* BOC revenues gained from optional expanded *local* services that themselves compete with IXC-provided intra-LATA toll and that BOCs are able to provide at below-access-charge prices specifically because of their ability to integrate the access and interexchange functions.

switched and special access services *that all nonaffiliated interexchange carriers must utilize in order to originate and terminate interLATA calls from and to BOC end user customers*.

32. Significantly, BOC entry into the *interLATA* market appears to have reversed the downward trend they had been experiencing with respect to *intraLATA* market share. Verizon's latest quarterly report indicates that BOC interLATA authority is halting the effect of intraLATA dialing parity on competition in the intraLATA market, reporting a net gain in intraLATA customers for each of the past five quarters.[50] Dr. Tardiff's analysis of the development of intraLATA toll competition using non-structural safeguards omits other facts regarding ILEC intraLATA toll pricing, special access services, and recent experience with the intraLATA toll market. For one, he claims that BOC intraLATA market share losses pre-dated equal access, citing a figure of 22% IXC share as far back as 1995.[51] Larger business users, whose aggregate long distance calling volumes were sufficient to justify the use of a dedicated connection between their premises and the IXC and who were thus not impacted by the lack of intraLATA dialing parity, often combined interLATA and intraLATA calling within the same service package. As a result, and especially before the introduction of equal access, the majority of BOC intraLATA market share losses through 1995 as cited by Dr. Tardiff consisted primarily of customers served over special access arrangements. Up until the implementation of intraLATA equal access presubscription and dialing parity, IXC shares of dial intraLATA toll were negligible. It was only after the introduction of intraLATA dialing parity, and requirements in the

50. *Verizon 3Q Report*, at 5.

51. Tardiff, at para. 9.

1996 *Act* and elsewhere demanding the elimination of access charge subsidies, that intraLATA competition became viable on a large scale and to residential users. But even today, the continuing ability of BOCs to provide intraLATA services on an integrated basis, to avoid paying access charges or even imputing such charges into their retail prices, and to offer "non-toll" optional expanded local calling arrangements that compete directly with IXC intraLATA toll services, have all worked to ensure continuing BOC dominance of the intraLATA services sector.

Information Services.

33. Dr. Tardiff observes that while BOCs are permitted to offer "information services" on an integrated basis with no OI&M separation requirements, they nevertheless maintain only a small share of the information services market. For example, Dr. Tardiff puts BOC (and GTE) shares of "voice mail" services at only 15% and notes that there are "hundreds of non-affiliated Internet service providers (ISPs)."[52]

34. In claiming that BOCs maintain only a 15% share of voice mail revenues, it is likely that Dr. Tardiff has applied an unduly expansive market definition that includes segments that BOCs do not specifically target or even serve. With respect to voice mail, BOCs are primarily engaged in *retail*-level individual mailbox offerings targeted to BOC residential and single-line business customers. BOCs do not typically compete for voice mail business from purchasers of multiple mailboxes, such as PBX users. BOCs also do not typically compete for voice mail

52. *Id.,* at para. 10.

business from paging or CMRS carriers or from CLECs. The primary value of BOC operational integration with respect to voice mail lies in the single mailbox services provided to the residential and small business market, and BOCs appear to dominate this sector.[53]

35. Dr. Tardiff does, however, conveniently *ignore* the one critically important aspect of BOC-provided ISP access — ADSL — in which the BOC *is* able to exert market power and leverage its control of the local market into the adjacent competitive market for Internet access. In fact, BOCs have come to *dominate* the growing ADSL-based "high-speed Internet access" market.[54]

Customer premises equipment (CPE) and inside wire.

36. At the time of the break-up of the former Bell System, the BOCs were forced to transfer their "embedded base" of customer premises equipment ("CPE") to AT&T and were required to provide new CPE through a separate affiliate. Without that embedded base of CPE as a foun-

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53. Verizon notes that its "bundles" services are driving penetration of "basic" vertical features such as Caller ID, and Voice Mail. According to Verizon, over 19% of consumer customers subscribe to a bundle. Many more are likely to subscribe to BOC voice mail separate from a bundle. *Verizon 3Q Report*, at 5.

54. As of June 30, 2001, the RBOC share of ADSL lines was 86.4%. As a percentage of high speed lines, the BOCs provided 32.2% of all high speed lines. *Inquiry Concerning the Deployment of Advanced Telecommunications Capability to All Americans in a Reasonable and Timely Fashion, and Possible Steps To Accelerate Such Deployment Pursuant to Section 706 of the Telecommunications Act of 1996*, CC Docket 98-146, Third Report, Rel. February 6, 2002, at Table 5.

dation, the BOCs chose not to reenter the CPE market, and have still not done so even though, since 1996, the BOCs have been permitted to provide CPE on an integrated basis.

37. In 1977 and 1978, the FCC adopted the Part 68 "equipment registration" program applicable to *all* CPE, whether provided by a BOC or other ILEC, or by the customer.[55] That action, together with the subsequent "unbundling" of the "primary instrument" from the basic dial tone line and the transfer of embedded CPE out of the BOCs, fundamentally and irreversibly changed the distribution channel for both consumer and business CPE. Rather than renting telephone sets and other station equipment as part of the process of ordering local telephone service, consumers were instead offered the ability to *purchase* this equipment outright through ordinary retail channels, such as Radio Shacks, K-Marts, and thousands of other retail outlets. CPE so purchased could then be plugged into the customer's telephone line in much the same way as electrical appliances were plugged into the customer's electric service. As a result, CPE was no longer limited to the familiar telephone handsets that were the mainstay of ILEC-provided equipment, and thousands of new consumer-oriented products have been introduced, *each one of which may be connected to the PSTN via the standard RJ-11 interface*. Business telephone systems — PBXs and the like — experienced a corresponding restructuring of distribution channels, with numerous new manufacturers and their retail dealers entering the market.

55. *Proposals for New or Revised Classes of Interstate and Foreign Message Toll Telephone Service (MTS) and Wide Area Telephone Service (WATS)*, Docket no. 19528, *Memorandum Opinion and Order*, Rel. June 20, 1977, 64 F.C.C.2d 1058; *Third Report and Order*, Rel. April 13, 1978, 67 F.C.C.2d 1255.

38. Put simply, the CPE "bottleneck" problem was solved by the simple adoption of the standard "RJ-11" plug and jack — and consumers and CPE providers don't even have to buy their RJ-11 jacks from the phone company, because the Commission had also deregulated another CPE-related bottleneck — inside wire. Since CPE interconnection is now accomplished by a standard RJ-11 plug-and-jack and since these products are now being sold by retail channels ranging from local convenience stores to specialized consumer electronics dealers, there is no particular cost or competitive benefit that a BOC could derive from the OI&M and marketing integration that is now permitted for CPE, and indeed no such integration has actually occurred because the BOCs are not in the CPE business to begin with. Thus, contrary to Dr. Tardiff's "example," the fact that CPE may be provided and marketed by BOCs on an integrated basis with local telephone service teaches *nothing* about what the BOCs will be able to achieve with respect to long distance remonopolization should the OI&M restriction be lifted with respect to interLATA services.

39. While Dr. Tardiff makes the affirmative statement that "[t]here is no evidence — nor have there, to our knowledge, ever been assertions" that the BOCs have attempted to exclude competitors in CPE,[56] Dr. Tardiff makes no such statement regarding inside wiring services. As with CPE, the BOCs do not have market power with respect to inside wire maintenance because there are no barriers to entry.[57] Interestingly, ILECs *have* attempted to preserve their preexisting

56. Tardiff, at para. 11.

57. *Detariffing the Installation and Maintenance of Inside Wiring*, CC Docket 79-105, Second Report and Order, March 12, 1986, 51 FR 8498 ("*Inside Wire Detariffing Order*"), recon, in part, Detariffing Recon., 1 FCC Rcd at 1190; further recon., Memorandum Opinion and (continued...)

monopoly in the inside wire maintenance business by exploiting preexisting relationships with monopoly local service customers, such as in attempting to sell deregulated "inside wire maintenance services' on inbound contacts from local service customers. For example, the California PUC has received numerous complaints that Pacific Bell ignores exactly the type of non-structural safeguards that Dr. Tardiff claims are successful in preventing monopoly abuses. As a non-structural safeguard, the California PUC required "the utilities to inform their customers that competitive alternatives may be available. This notification should be provided during customer calls to 611 repair services and when a repair employee is on the customer's premises and has identified a possible inside wire problem."[58] Complaints were lodged with the CPUC by the Office of the Ratepayer Advocate and The Utility Reform Network that Pacific Bell violated this safeguard.[59] Such complaints illustrate the inadequacies of non-structural safeguards. Other

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57. (...continued)
Order, 3 FCC Rcd 1719.

58. *In the Matter of the Application of Pacific Bell, a corporation, for authority to increase certain intrastate rates and charges applicable to telephone services furnished within the State of California; And Related Matters*, Before the California Public Utilities Commission, Decision No. 90-06-069, June 20, 1990, 36 CPUC 2d 609, 626.

59. *In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, for Authority to Categorize Business Inside Wire Repair, Interexchange Carrier Directory Assistance, Operator Assistance Service and Inmate Call Control Service as Category III Service; In the Matter of the Application of Pacific Bell (U 1001 C), a corporation, For Authority to Categorize Residential Inside Wire Repair as a Category III Service*, Before the California Public Utilities Commission, CPUC Decision No. 99-09-036, September 2, 1999, 1999 Cal. PUC LEXIS 603, *18. This requirement was clarified in *The Utility Consumers' Action Network, Complainant, vs. Pacific Bell (U 1001 C), Defendant; And Related Matters*, Before the California Public Utilities Commission, CPUC Decision No. 01-09-058, September 20, 2001, 2001 Cal. PUC LEXIS 914, *57. The CPUC did not make any findings or conclusions about Pacific's compliance with these requirements, however, the decision directs Pacific Bell to
(continued...)

BOCs have been accused of engaging in "negative option" marketing of their "optional" inside wire maintenance services, leaving the monthly charge on the customer's bill as of the deregulation date until such time as the customer affirmatively asks that the "service" be discontinued.[60]

BOCs have demonstrated their ability to engage in "double marginalization" by maximizing their profits with respect to their aggregate incremental costs rather than with respect to "imputed" access charges, and to effect price squeezes and engage in other predatory conduct with respect to nonaffiliated long distance rivals.

40. In my August 5 and 26, 2002 Declarations in WC Docket No. 02-112, I made reference to a recent paper by Prof. Jerry A. Hausman and others[61] in which the authors claimed that BOC long distance affiliates were offering service (in states with Section 271 authority) at lower prices than non-BOC-affiliated IXCs, and advanced as a theoretical explanation for this observed result the ability of BOCs to engage in "double marginalization" as between their ILEC and long distance operations. I noted that while I do not agree with the authors' claimed empirical findings as to price relationships, "if the Commission were to end the requirement that the BOC

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59. (...continued)
disclose such information. *See The Utility Consumers' Action Network, Complainant, vs. Pacific Bell (U 1001 C), Defendant. And Related Matters*, Before the California Public Utilities Commission, CPUC Decision No. 02-02-027, February 7, 2002, 2002 Cal. PUC LEXIS 189, *34.

60. *See, e.g. Pennsylvania Public Utility Commission v. The Bell Telephone Company of Pennsylvania*, Docket No. 832316, Before the Pennsylvania Public Utilities Commission, Opinion and Order, Rel. April 16, 1984, 1984 Pa. PUC LEXIS 53.

61. Jerry A. Hausman, Gregory K. Leonard and J. Gregory Sidak, "The Consumer-Welfare Benefits from Bell Company Entry into Long-Distance Telecommunications: Empirical Evidence from New York and Texas" ("Hausman/Leonard/Sidak" or "HLS"), unpublished study, dated May 2002.

operate its in-region long distance business out of a separate affiliate, and were no longer to require that the BOC long distance business activity operate independently with respect to, and transact all business at arm's length with, the BOC's local exchange operations, the BOC will be then capable of engaging in "double marginalization" pricing and in imposing a price squeeze with respect to access charges and retail long distance rates."[62]

Dr. Hausman's theory of double marginalization confirms a BOC's incentive and ability to engage in predation.

41. Dr. Tardiff's "response" to this observation, which is buried in a single footnote, suggests that my reference to the Hausman *et al* paper is "puzzling" and "internally inconsistent" because I dispute Hausman's empirical findings with respect to BOC long distance prices while at the same time appear to be accepting his explanation as to why BOC long distance prices are lower.[63] Dr. Tardiff once again misses the point: Hausman's contention that BOCs engage in profit-maximization across their combined local and long distance components represents an admission that BOCs do not adhere to access imputation requirements, such as those set out at 47 U.S.C. §272(e)(3). The fact that BOC long distance prices in the states studied by Hausman (New York and Texas) had not *as of that date* been reduced relative to pre-BOC entry IXC prices does not alter or diminish the importance of that admission. Significantly, while on the one hand contending that BOC prices satisfy access imputation requirements (*i.e.*, that BOCs are *not* engaging in "double marginalization"), Dr. Tardiff, also concedes, as I noted above, that

62. Reply Declaration of Lee L. Selwyn, at para. 32.

63. Tardiff, at para. 22, footnote 33.

IXCs "had to compete against inexpensive local calling within the LATA." The "local calling" to which Dr. Tardiff refers would appear to consist of calls placed within "optional" expanded local calling areas that compete directly with intraLATA toll services being provided by IXCs.[64] Unlike those "toll" services, however, these BOC "local" rates are not typically required to, and generally do not, exceed access charges, resulting in precisely the type of interLATA price squeeze vis-a-vis IXCs the existence of which is being denied by Dr. Tardiff.

42. The suggestion that BOCs profit-maximize with respect to *actual* incremental costs — not "opportunity costs" as claimed by Dr. Tardiff[65] — came not from me, but from BOC consultants Hausman, Leonard and Sidak.[66] Since the BOCs already have a relationship with the vast majority of customers that (absent BOC entry) would buy their long distance service from the IXCs, the incremental cost *to the BOC* of carrying these customers' long distance traffic, of marketing long distance to these customers, or of including long distance charges on its customers' local service bills, is considerably less when accomplished on an integrated basis than the stand-alone cost level that confronts an IXC without an extensive local service customer base. Because the demand for long distance service is downward sloping and not perfectly elastic, Hausman *et al* note that a BOC's profit-maximization point relative to its lower costs will be at a lower price than would be set by rivals that are confronted with volume-insensitive access

64. See footnote 48, *supra*.

65. Tardiff, at para. 22.

66. *See*, Hausman/Leonard/Sidak, at 17.

charges, thus undercutting Dr. Tardiff's "opportunity cost" argument and resulting in precisely the type of price squeeze that I have described.

43. Double marginalization and the price squeezes that result therefrom are exactly the types of BOC conduct that Congress had in mind when it established the "operate independently" requirements at Section 272(b)(1). Dr. Tardiff and other BOC economists persist in their efforts to dismiss the possibility of predation and price squeezes being pursued by their clients if forbearance from the OI&M separation requirement is granted, and claim, among other things, that under price cap regulation the BOCs have no incentive to engage in anticompetitive conduct.[67] However, if their rhetoric had any merit, which it does not, there would have been no reason for Congress to have established separate affiliate, nondiscrimination, imputation and other safeguards *aimed precisely at limiting such potentially anticompetitive practices*. If through such devices the BOCs are successful in forcing their nonaffiliated rivals out of the long distance business, they will be in a position to increase long distance prices with little concern about competitive reaction. The requirements of Section 272 were designed to attenuate the BOCs' integration and incumbency advantages *while effective competition in the local market is developing.* Congress specifically recognized that, with respect to this aspect of BOC conduct, it is not merely sufficient for the market to be "open" to competition to protect consumers and competitors against anticompetitive pricing on the part of the BOCs.

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67. *Section 272(f)(1) Sunset of the BOC Separate Affiliate and Related Requirements*, WC Docket No. 02-112, Comments filed August 5, 2002, *Verizon Comments*, at 18; *SBC Comments*, at 10-12; *Qwest Comments*, at 13.

Price Cap Regulations Creates Incentives to Misallocate costs.

44. Price cap regulation does not negate the possibility of cross-subsidization and predatory conduct; in fact, it works to support and sustain it. As I discussed in my August 26, 2002 Reply Declaration, under rate of return regulation if the BOC sets the price of an essential service (one that is subject to the Section 272(e)(3) imputation requirement) above cost, then its own "imputation payments" would be included in determining the appropriate price level for the remainder of its regulated services. Thus, if the BOC were to set an excessive price for switched access, for example, the excess profits resulting from imputation payments would have to be flowed through to its basic service ratepayers in the form of lower prices for other (retail) services. By contrast, under price caps, the BOC has no such requirement: It can overcharge its own competitive business unit without being forced to flow-through the excess profits resulting from this strategy; in effect, it will simply be shifting profits from one "pocket" into another. And in other situations, where the inter-affiliate transfer price is not used to establish the cash price that non-affiliated carriers would pay the BOC for like services (*e.g.*, because the BOC does not provide "like services" to the nonaffiliated carrier — joint marketing services, legal and lobbying services, are good examples), the BOC can *underprice* the services it provides to its affiliate, effectively negating the *overcharge* that it had applied where the transfer price matters (*i.e.*, where it is used as a basis for the cash price that nonaffiliated carriers pay for an essential service). The point is that under "pure" price caps, where the BOC is not subject to any cap on earnings or any obligation to share excess earnings, payments for inter-affiliate transfers have no economic or financial consequence for the corporation as a whole, they amount to shifting money from one pocket to another. And, of course, if the separate affiliate requirement is

allowed to sunset, the BOCs will no longer be under any obligation to post or otherwise make public — or for that matter even use — any "transfer prices" applicable to services furnished by the BOC to its (integrated) long distance business activity.

45. Significantly, empirical evidence shows that BOC market power in the local market remains pervasive enough to make "double marginalization" unnecessary at the present time. Dr. Tardiff states that the evidence presented in my Reply Declaration noting that SBC had *raised* is prices shortly after entering the long distance market "is not indicative of predatory behavior that would lead to monopolization, because in that instance, price increases occur *after* rivals have left the market."[68] Dr. Tardiff misses the point: SBC was *able* to raise its prices in the face of IXC competition precisely because its integration and incumbency were more than sufficient to overcome any negative demand consequences arising from its price increase. As I noted earlier, SBC has stated that it is signing up "in excess of 50 percent" of inbound local service customers for its long distance service as a result of its joint marketing program. With that sort of "take rate," it's no wonder that SBC raised its prices, because it obviously concluded that price was not the primary basis for customer choice of long distance carrier. If SBC felt that it was able to raise prices with a "take rate" that was only "in excess of 50 percent," it most certainly would have little concern about further price increases as that "take rate" improved, which is exactly what would occur as rival long distance carriers cut back on their marketing or exited the long distance business altogether. SBC's demonstrated ability to raise prices while concurrently increasing its overall market share attests to SBC's ability to extend its local market

68. Tardiff, at para. 22, fn. 34.

power into the long distance market — the essential ingredient for continued predatory pricing and anticompetitive conduct.

Conclusion

46. Verizon's sole basis for seeking Commission forbearance from enforcing the OI&M requirements of 47 U.S.C. §272(b)(1) are alleged cost savings arising from integrated operation, but the Company has provided no credible or verifiable support for the actual magnitude of savings that it claims will arise. On the other hand, there are serious and fundamental risks to competition in the long distance market that would arise if the OI&M separation requirements are rescinded prematurely, before the BOCs' extensive market power in the *local service market* is diminished. Additionally, and contrary to Verizon's contentions, even if Verizon's assessment of cost savings is accurate, there is no basis to assume or expect that such savings will in fact be flowed through to consumers. 47 U.S.C. §272(b)(5) *requires* that the long distance affiliate pay the BOC the fair market value of all BOC-provided services *whether furnished on an integrated basis or as specific interaffiliate transfers*. Accordingly, the affiliate should see no specific reduction in the transfer price it pays the BOC for these services and, indeed, if the integration gains were conferred upon the affiliate and were reflected in lower long distance prices to consumers, that would simply impose a price squeeze upon nonaffiliated IXC that do not have the local/long distance integration opportunity. If one then assumes that the integration gains would inure instead to the BOC ILEC entity, there is no requirement or expectation, as a result of the prevalence of price cap regulation at both the state and federal level, for the BOC to flow through those savings to its local service customers. Without any such flow-through, whatever

integration efficiencies may be realized would flow directly and entirely to Verizon's "bottom line." Accordingly, the only "beneficiary" of the alleged integration efficiencies would be Verizon's shareholders, but the risks to competition and to individual competitors are considerable and real. On the basis of a straightforward cost/benefit analysis, it should be apparently that Verizon's *Petition* must be denied.

The foregoing statements are true and correct to the best of my knowledge, information, and belief.

Lee L. Selwyn